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Panel: Capital Allocation in Complex Family Enterprises During a Crisis

Parametric has worked with family offices and the advisors who serve them since 1992. One of the things we appreciate most about working with family offices is the chance to learn from some of the world's best investors and wealth stewards. One question we hear often is "What are families like mine doing?" The interest in this question is even greater during periods of crisis, such as the COVID-19 pandemic.

To provide some answers, Parametric managing director Bob Breshock, who leads our Family Office Advisory Group, conducted a panel interview with three industry veterans who have founded, led, or consulted for family offices:

- Stuart Lucas, co-managing partner and chief investment officer at Wealth Strategist Partners
- Christine Galloway, former president and CEO of the Okabena Company
- Mark Pockell, family office consultant and former senior director of family office services at BNY Mellon

Following are excerpts of this discussion for insights into the unique challenges facing family offices.

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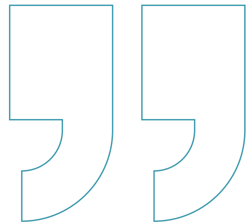

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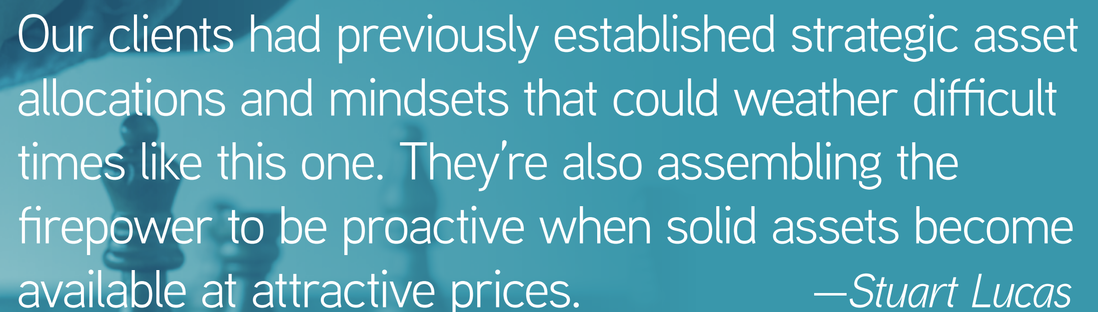
Investment management and opportunities

How are families approaching capital allocation now? Are they playing defense? Is it too early to play offense? How might this be different for families with operating companies?

Stuart Lucas: Most complex family enterprises we know have been playing defense so far. In some cases it's because they have no choice. In other cases it's to set the stage for strengthening their market position as the crisis wanes. You raise a very good question about whether it's too early to play offense. There's still so much we don't know. In 100 years, we've never had a crisis like this one. I think this battle against COVID-19 is going to be long, with lots of cross-currents and surprises that the stock market isn't reflecting today. In the dotcom bust of 2000–2002 and the financial crisis of 2008–2009 uncertainty and negative surprises finally led to exhaustion and capitulation. Only then could a bottom build. I'm telling the families we work with that we don't think it's time yet to play offense.

It would be wonderful if we've already experienced the bottom of a V-shaped recovery and I'm wrong to keep the brakes on, especially since a quick remedy for COVID-19 could save many thousands of lives. But my best guess about the virus and the required economic response to it suggests we've got a ways to go, a series of improvements followed by relapses. For the first time in generations, we have a trifecta of serious health, economic, and financial factors. This makes for higher levels of uncertainty than I've ever experienced. Fortunately, our clients had previously established strategic asset allocations and mindsets that could weather difficult times like this one. They're also assembling the firepower to be proactive when solid assets become available at attractive prices.

The current crisis brings into particularly sharp focus another aspect of capital allocation: the governance process. We work closely with clients to build good governance that can anticipate and withstand stress and uncertainty and then adapt. Historically many families eschewed debt in their operating business, and they channeled excess cash flow from the business into the family office to diversify and to reduce risk. Now, with interest rates so low, they're looking to borrow more heavily because they expect the risk-adjusted opportunity set to far outweigh the cost of capital. They can borrow on fixed rates with more attractive collateral requirements in



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the business. The additional firepower may remain in the business or be distributed to invest in financial assets. For some other families, this may be the first and only time in decades where it might make more sense today to reallocate some financial assets back to the business, either to protect it or to finance once-in-a-generation acquisitions. Good governance of the capital allocation process across a complex family enterprise can adapt to a wide range of circumstances and can find opportunity wherever it presents itself, especially in challenging times.

Christine Galloway: I just sat in on a board meeting with a private company that has little or no leverage. Interestingly enough, that took up a lot of the discussion. Here's my perception of what's going on right now: They're trying to manage the existing business and figure out how to hold that together, then pivot from that business into other opportunities. The challenge is focus as they work to adjust current operations to the realities of COVID-19 while exploring scenarios that will grow or change their business. It's truly a balancing act and speaks to the defense versus offense dilemma.

I believe families and family businesses are using this as an opportunity to ask the tough questions about what's next. While the speed at which this situation evolved forced them to go on defense in the short term, it's stimulating and accelerating longer-term planning among those that have financial flexibility.

Are cash flow and liquidity generally concerns? Have most families addressed this since the global financial crisis in 2008?

CG: Based on the families with whom I've worked, I believe most developed an awareness of the need to structure their portfolios to withstand unforeseen events after 2008–2009, although it's likely that very few anticipated an event exactly like the one we're currently experiencing. As a general statement, I believe families have been more prudent about making sure there's adequate liquidity and access to cash in their portfolios.

Mark Pockell: My banking contacts tell me that there's been great demand for lines of credit from families with operating businesses, with some seeking very large lines of credit for potential use. It may be too early to tell how and if the lines of credit will be deployed, since we are only five weeks into this situation. With these very volatile markets, I think they're smart to prepare either to sustain challenged cash flows or to invest opportunistically through borrowing at these relatively low interest rates.

In contrast to Chris, I've seen some families panicking a little in regard to cash needs, and they've been selling municipal bonds, more so than equities. I'm aware of families selling munis to raise 18 months of spending needs. Because of what happened in 2008 and all the capital requirements, families I know consider banks relatively safe and a comfortable place to park the cash.

How are families approaching rebalancing? Are there investments or asset classes that you might reconsider at this time?

SL: For four or five years, we've advised our clients to have a very tight funnel around leveraged buyouts. Purchase multiples are too high, leverage ratios are too aggressive, and so is the pro forma accounting on which these numbers are based. We see no reason to change our outlook today, even though we've been an outlier.

In addition to ascertaining what a safe investment is, another challenge with the mechanics of rebalancing today is how to mark your private assets. You should probably mark down your private equity and some of your private real estate investments. In our case, we would continue at a fairly low level of investment in private equity. A lot of institutions that have been leaning into private equity are suddenly concerned that either they're overcommitted, because other parts of their asset allocation have shrunk, or that what they thought was a self-funding investment program no longer is. If distributions dry up for the next two years, they're suddenly not sure how they're going to fund the capital calls. Reunderwriting your private equity book or your private investments book is worth doing now. But it may cause you to delay rebalancing or to refocus how you're allocating your research time budget. Today, our investment research is more focused on public equity than private equity, but we're not acting on it—yet.

MP: At this point, many families are just keeping to their strategic allocation and looking at opportunities. If they're underweight in something, do they go into it or just allow for an overweight in some classes and an underweight in other classes? I think right now we're in a holding pattern for at least a few more weeks to see what's going on. We're down maybe 12% to 15% after the last run up, and last year we were up 30%. I always looked at it and said, "As long as we're able to get 10% a year, I'm happy." Averaging it out, we're not too bad over the last two years. But we're not being complacent; we're waiting and watching and we're prepared to act. Markets are valuing companies six months from today; it will be interesting to see how they perform over the next several months.

CG: That's been my experience as well. Families have opportunistically harvested losses and looked at upgrading certain managers, because they now have capacity. But that's within the asset classes that they already have in place. They're not making dramatic shifts among asset classes and resetting policy. Managers that were once closed are now taking new capital.

SL: Have you come across data on whether environments like now actually do produce more alpha for active management?

CG: I haven't seen data that relates directly to short-term, episodic events such as the one we're experiencing. I know that certain CIOs have biases one way or the other, and they'll typically act on those biases whether or not there's data to support them.

MP: One thing I did is look at three scenarios. One was 100% active in its allocation to public equity. Another one was about 50% passive and 50% active based on the asset class, and another one was 30% passive and 70% active. I looked back over about 10 years' worth of data and reviewed the results. At the end of the day they were very, very close to each. Whatever road you took, you ended up pretty close to being where you wanted to be.

Trying to find active managers who can consistently beat the benchmarks over long periods of time requires extensive research. One would have to be willing to switch managers on a frequent basis as necessary. I agree with Chris that advisors and investors have biases about active and passive and which asset class is best suited to each. I don't know what the data shows on whether active beats passive over 10 years, but I think the pretax performance is similar.

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—Christine Galloway

Tax and estate planning

How are families addressing potential income tax increases? With asset values depressed and interest rates low, are you seeing particular approaches to estate planning?

SL: Less than three months ago, we were 11 years into a bull market. Even with the market swoon, tax-conscious long-term investors have a lot of stock with substantial unrealized capital gains. If they use a tax-loss harvesting strategy, unrealized capital gains are likely to be even higher. This tax deferral has been a real benefit. But if capital gains tax rates go up a lot in the next few years and stay that way, it may be time to consider harvesting gains rather than losses before tax rates rise. If you have a deferred tax liability of $100 today and tax rates go up by 50%, that $100 will grow instantly to $150, and your net assets drop by $50 with a vote in Congress and the stroke of a presidential pen. On the other hand, if your deferred tax liability is zero when tax rates jump, the ability to compound deferred taxes from that point increases in value. To come full circle, when it comes to capital allocation, taxable investors need to juggle the future valuation of investments plus the future of tax rates.

MP: The families with whom I work closely have already taken advantage of just about everything that they could, at this point, from an estate planning perspective under current law. We expect there'll be changes to the tax law if a new administration comes in; some of the favorable provisions in the estate tax may go away. So we've been making sure that we've gotten everything taken care of. But if a family hasn't, it's obviously a good time to move some assets over at these lower values.

CG: Families are doing additional grantor retained annuity trusts (GRATs), in addition to those they've already done, because of the low applicable federal rate (AFR).* Intrafamily loans are attractive for the same reason and are being used as a wealth transfer vehicle. Annual gifting has also been accelerated because of the opportunity to gift depreciated assets.

SL: One of the things that I strategize about with my clients that's also a centerpiece of my new book, *The Taxable Investor's Manifesto*, is the power of working at the intersection of investment, tax, and estate planning. As Mark and Chris describe, designing intrafamily loans or setting up new GRATs funded with assets under price pressure are great examples of that intersection. Another planning opportunity is to review grantor trusts established some time ago for opportunities to realize profits before tax rates rise and for the grantor to pay the taxes. Trusts with this characteristic are called Intentionally Defective Grantor Trusts. In some cases, it may also make sense to replace some assets currently in a grantor trust with others outside the trust. For all these reasons, now's a good time for families to sit down with their investment, tax, and estate planning advisors to explore opportunity at those intersections.

* GRATs are designed to transfer appreciation out of the grantor's estate with minimal to no gift tax. GRATs are funded with assets that are expected to grow significantly in value. The assets are placed in an irrevocable trust that requires fixed annual payments to the grantor for a certain number of years. The idea is during that term of the GRAT, any increase in value will benefit the remainder beneficiary. This technique is currently more attractive due to the current low interest rate environment. The low interest rate (or discount rate) applied to value the assets transferred to the GRAT will result in a smaller or zero taxable gift when the GRAT is created.

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Responsible investing and philanthropy

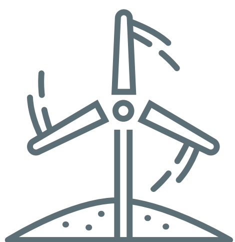
Has the pandemic changed the way families are thinking about socially responsible, ESG, impact, or sustainable investing?

MP: I did ask my clients and a few external advisors what they're noticing. The answer, unfortunately, is that nothing has changed at this time. They haven't thought about this yet, which is a bit of a surprise. This will be a topic at future investment meetings. Some advisors have started to see a little bit on the foundation end; there has been some raising of cash to do grants, but they don't have insight as to where those funds are being allocated.

I can give you a direct response for the clients I work with. One of them doesn't have a conviction one way or the other about ESG. They do their own investing, for the most part, in specific companies and through private equity. The other clients have discussed ESG, particularly in regard to carbon or fossil fuel mandates, but haven't yet pulled the trigger. This is due to potentially lower returns on trusts where they're trustees. I would expect that, in the coming months, clients will pay more attention to ESG—not only for environmental reasons, but also as it relates to how companies treat their workforce during this pandemic.

CG: Three of the five families with whom I work haven't pursued ESG investing to any degree. I think it's a little too early to know whether this current set of facts and circumstances is going to change their investment philosophy. There are two families that are very, very active in this space. One of the families has been focused on environmental issues, climate change in particular. The other family has taken a more holistic approach: They've actively screened their equity portfolio to determine what the carbon footprint of that portfolio is, for example, and begun to strategize as to how to reduce that over time. They've also been very proactive about finding social impact opportunities, not just in the US but worldwide, and they screen and hire new managers whose investment philosophy and execution are aligned with their values around good governance practices. It seems to be all over the map.

SL: Until the crisis, most of the focus of ESG was on the environment. I now think there is a high chance the governance piece and the social piece will become more prominent. For years, Tom Wilson—the long-serving CEO of Allstate and the chair of the executive committee of the National Chamber of Commerce—has been passionate about highlighting the need for job creation in large corporations. I hope his message will resonate now. Well before COVID-19, he was encouraging investors and boards of directors to ask tough questions about job creation, fair wages, and reskilling efforts when technology makes jobs redundant. He also calls on companies to create transparent metrics around these factors so they're held accountable for more than bottom-line profits. One of my favorite quotes from Tom is "Being broke while working isn't an American value." The S&P 500® profit margins have been on an increasing trend for 30 years. The shrinking of labor costs has been an important contributor to that trend. In the years ahead, I think these trends will reverse: Labor costs will increase, putting pressure on margins. Whether you're an ESG investor or not, being aware of ESG is going to be even more important in a post-COVID-19 world.



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As it relates to whether or not ESG portfolios outperform or underperform, I think that remains an open question and is likely to remain an open question for a long time. I'm still not sure in my own mind, after having studied this for some years now, how to define ESG portfolios. For example, is a coal-fired power generation company potentially an ESG business? I think if you lined up 100 people, 95 of them would say no. But AES, one of the largest coal-powered utilities in the world, has pledged that it's going to drop its coal-fired production from 34% of revenue today down to about 10% in the next decade. If they can achieve that, AES will be one of the most remarkable carbon-reducing businesses in the world. Even though it's a coal-based utility, it actually could be incredible in terms of both reducing carbon and being a great financial investment.

Has the pandemic changed the approach to philanthropy? Are private foundations or donor-advised funds doing something different or more now to address some urgent needs in the community?

MP: That's one of the things I'm able to look at for my clients. Though they may not have an ESG portfolio, their foundations have been more active. I see their gifts going through the process, and they appear to be more targeted grants to communities.

CG: I believe any shift in giving strategies in response to COVID-19 has been more opportunistic and doesn't yet represent a fundamental shift for most families. There are a few very high-profile foundations for which this isn't true—the Gates Foundation, for example. Most family foundations with which I'm familiar are still trying to digest the impact of COVID-19 and determine where the gaps might be. In some cases, previously approved grant payments have been accelerated to address urgent needs.

SL: One of the intriguing things about ESG in a foundation setting is that, traditionally, people have had a pool of assets from which they distribute 5% a year to do good. If ESG strategies are embedded into the balance sheet, now 100% of the foundation's assets are working to do good, just in different ways. Whether the ESG strategies are applied to specific donor intent or to a broader philanthropic purpose, it can be a really positive thing and I think we're going to see more of it.

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Offices have been systematically upgrading their systems and security over the last 10 years as they've focused on managing risk within their organizations. I believe it's a function of management's planning capabilities and the willingness to invest in the people and the systems that allow the office to function successfully under circumstances like these.

—Christine Galloway

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Governance and operations

Many COVID-19 response issues escalated all at once. What information can we share while working from home? Are our systems robust enough to maintain security and yet deliver the kind of data that we want?

CG: My experience is that the transition to working from home for most family offices has been fairly seamless. Offices have been systematically upgrading their systems and security over the last 10 years as they've focused on managing risk within their organizations. I believe it's a function of management's planning capabilities and the willingness to invest in the people and the systems that allow the office to function successfully under circumstances like these. Among the offices that I work with, all have disaster recovery plans in place. Many conducted real-time tests of these plans, which made the transition to working remotely relatively painless.

MP: Many family offices had a plan in place in case there was a disruption in the office for whatever reason. It could be a storm, it could be a fire, it could be any kind of situation that would cause people not to be able to get into the office, yet work has to get done. Fortunately there was a lot of thought involved with how they operate if they couldn't get into the office. They put it into practice, and they would test periodically and make sure everything was working properly on a remote basis. In some cases the amount of testing wasn't as thorough as one would like, but it did work and they were able to work remotely. Certainly this was easier for those offices structured as virtual family offices, since they were already less reliant on staff housed in one location.

This is different than a generic market pullback; it has a public health component to it that's still being resolved. Is it too early to say we've learned something from this event? Do you see clear signs of what family offices need to do better going forward?

MP: I think you'll see maybe a few results from this. Do we need to have as much space as we currently have? Do we have to pay this kind of rental expense for a certain space if we really can have some of the staff operate remotely for most of the time? I think that down the road there will be more remotely working staff and less need for what can be fairly expensive real estate. Technology has improved in the sense of being able to have the information that you need at your homes. With Zoom-type applications, you can meet face-to-face with family members or fellow staff members and at least be able to have discussions that way. I work mostly with virtual family offices now.

Down the road there will be more remotely working staff and less need for what can be fairly expensive real estate. Technology has improved in the sense of being able to have the information that you need at your homes. *—Mark Pockell*

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CG: My perception is that most of these offices are actually sitting back and saying, "Oh, my gosh! We're much more resilient than we thought we were!" Some of them are beginning to ask, "Do we really need this brick and mortar? We're actually operating amazingly efficiently. We're getting the work done." These tend to be smaller offices.

MP: Smaller single-family offices with maybe seven or 10 people in the office.

CG: One question I hear them asking is, "Do we need to revisit what we really need to be successful in managing the families well?"

SL: I see an opportunity to talk to family members about managing through challenging times. With little inconvenience, there are opportunities to manage personal budgets more tightly. Learning this firsthand is a powerful lesson, especially for young people. Current circumstances highlight that the value of a dollar saved is significantly greater than a dollar spent. Discussing openly the vicissitudes of life and the privileged position that wealthy people have to manage and even be entrepreneurial in the face of uncertainty helps to shape family culture. Families that are resilient, creative, and opportunistic are the ones who survive and thrive. There are lots of teachable moments all around us now.

The other opportunity is in the area of governance, which is especially relevant for first-generation family enterprises. The ability of COVID-19 to attack anyone at any time, especially people in their 60s and beyond, puts into stark relief that we are all mortal. Building into governance a redundancy or succession plan that anticipates both gradual transitions and sudden unexpected change is simply good planning. You just can't be 100% certain that the family matriarch or patriarch is going to be there to lead next week, next month, or next year. In normal times, especially in first-generation families, it's very hard to raise this issue, to get it onto the family's agenda, and to bake it into a governance process. This crisis may present an opportunity to do that.

Is it the case that succession planning is just difficult for people to look at, because it means moving on from the current generation and potentially strong leadership? Is this a topic where families naturally drag their feet?

SL: Succession is a tough subject under any circumstance; the interplay of human nature and success makes it so. When you've been in charge since your 20s, 30s, or 40s and you've been very successful, and you like that role and responsibility, and you dedicated your life to the task, you may not know anything different. You're now in your 60s, 70s, or 80s, and it takes a particular type of insight and persona to identify and empower successors—family members or professional managers—and to step away and give them the freedom and the accountability to do their job without you.

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If you would like to connect with our panelists or have questions about the topics discussed in this interview, please contact your Parametric regional representative.

Christine Galloway

Christine Galloway is the retired president and CEO of the Okabena Company, an established office serving the Dayton family. She currently serves as a director and/or trustee on various family office, private company, and nonprofit boards. Prior to joining Okabena, she held management positions at the Harris Bank in Chicago. Chris earned her MBA from the Kellogg Graduate School of Management at Northwestern University.

Mark Pockell

Mark Pockell is a veteran family office consultant, specializing in streamlining the transition of family offices to virtual offices and revamping their investments, accounting, tax, and legal needs. He previously served as senior director of family office services at BNY Mellon, providing a knowledge base to over 100 family offices. Prior to this, he served as the CEO of the CCC Alliance in Boston. Mark received his MBA from Suffolk University.

Stuart Lucas

Stuart E. Lucas is founder, co-managing partner, and chief investment officer of Wealth Strategist Partners, advising large complex families on the financial, business, and cultural dimensions of their enterprises. He co-directs the University of Chicago Booth School of Business's Private Wealth Management program, which has served over 1,000 wealthy individuals and families. His bestselling first book, *Wealth: Grow It and Protect It* (FT Press), has been published on three continents. His new book, *The Taxable Investor's Manifesto: Wealth Management Strategies to Last a Lifetime* (Wiley), is now available. Stuart earned his MBA from Harvard Business School and holds the Chartered Financial Analyst designation.

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